STATE OF MAINE
PUBLIC UTILITIES COMMISSION

Docket No. 99-851

September 25, 2003

PUBLIC UTILITIES COMMISSION
Investigation into Verizon Maine's Alternative Form of Regulation

ORDER REINSTATING AFOR

WELCH, Chairman; DIAMOND and REISHUS, Commissioners

I. SUMMARY

In this Order, we reinstate the alternative form of regulation (AFOR) for Verizon that was vacated in February 2003 by the Supreme Judicial Court sitting as the Law Court. We find that it is not possible to make the comparative finding described in 35-A M.R.S.A. § 9103(1) that, over the five-year duration of the AFOR, rates for local service would be no higher under the AFOR than under traditional rate-of-return (ROR) regulation, at least with the degree of certainty indicated by the Court. Instead, we make the alternative finding permitted by 35-A M.R.S.A. § 9103 and described in the Court's opinion, i.e., we find that it is not in the public interest to make the comparative finding and assurance described in section 9103(1). We find, however, because of the benefits of the AFOR we adopted in June 2001, it is in the public interest to reinstate that AFOR notwithstanding our inability to make the comparative finding and assurance described in Section 9103(1).

Regulation under the reinstated AFOR will be identical to that described in the June 25, 2001 Order vacated by the Law Court. It will consist of a rate cap and stay-out for local exchange service rates (subject to increases for exogenous events), rate caps and stay-outs for directory assistance and operator services, pricing flexibility for retail toll and optional services, and application of the Service Quality Index (SQI).

II. PROCEDURAL BACKGROUND

On February 28, 2003, the Maine Supreme Judicial Court, sitting as the Law Court, vacated this Commission's June 25, 2001 AFOR Order and remanded the case for "further proceedings consistent with this opinion." *Office of the Public Advocate v. Public Utilities Commission and Verizon New England, Inc*., 2003 ME 23, 816 A.2d 833 (*OPA v. PUC/Verizon* or 2003 ME 23). On March 19, 2003, we issued a Notice of Further Proceedings Following Remand (NFR). The NFR described a number of issues we needed to consider in order to determine whether to order a continued AFOR for Verizon. The NFR requested the parties to file briefs that addressed the issues we

decide in this Order.[1] We also solicited further comments in August 2003. In response, Verizon Maine (Verizon), the Public Advocate (OPA) and the American Association of Retired Persons (AARP) filed briefs or comments.

III. THE SECTION 9103(1) ISSUE

Based on the filings by the parties, we are persuaded that in order to comply with the literal meaning of 9103(1), we would need not only something approaching a full rate case (as advocated by the Public Advocate and AARP) but also accurate forecasts of what subsequent rate cases would produce over the period of an AFOR, i.e. at least five years. For the reasons explained below, we conclude that literal compliance with the "not be required to pay more [under an AFOR]" than they would under traditional . . . regulation" language is impossible. Predictive certainty cannot be achieved by the regulatory process, however elaborate. We therefore will follow the alternative described in paragraph 29 of the Law Court's February opinion and find, specifically, that we "cannot make the ensurance required by section 9103(1), regardless of what kind of investigation [we conduct], and further [find] that it is better to proceed with the AFOR without fully complying with the literal language of 9103(1)." We find that attempting to achieve what the Court characterized as "full technical compliance" with the condition stated in Section 9103(1) is not in the best interests of ratepayers.[2] We therefore adopt the AFOR set forth in the June 25, 2001 order that was the subject of the appeal and remand, and will report that decision and the reasons for the decision to the Legislature in our annual report required by section 9105.[3]

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[1] In an earlier round of briefing, the parties addressed (1) whether the Commission should continue in effect the increase in local rates of $1.78, which were ordered in June of 2001 (in the same order establishing the revised AFOR) for the purpose of offsetting access revenues losses resulting from access rate reductions Verizon had been required by law to make at that time, and (2) the form of interim regulation pending the decisions in this Order. On June 23 and July 14 (in a two-part order), the Commission decided those issues.

[2] The relevant portion of ¶ 29 of the Court's opinion states:

> The Commission, however, may finally conclude that it cannot make the ensurance required by section 9103(1), regardless of what kind of investigation it conducts, and further conclude that it is better to proceed with the AFOR without fully complying with the literal language of section 9103(1). If so, section 9103 allows the Commission to adopt an AFOR if it "specifically finds that [full technical compliance with section 9103(1) is] not in the best interests of ratepayers…"

[3] We will supplement the annual report that we filed with the Legislature on August 28, 2003.

In order to make the finding that would comply with the literal language of 9103(1), we would, in the words of the court, have to develop "some reliable estimate, based on objective data, of what local rates for Verizon would be [for the AFOR period] under a ROR system." The material presented to us by both Verizon and the Public Advocate demonstrate that while it may be possible to achieve some reasonable *probability* that rates under an AFOR will be no higher than rates under ROR regulation, the near *certainty* sought by section 9103(1) is impossible to achieve. As the court noted, the original language of the statute would have called only for a likelihood, but the final language, which requires that the Commission "ensure" that ratepayers would not pay higher rates under an AFOR, requires a degree of certainty substantially beyond a likelihood.

Our conclusion that such certainty cannot be achieved is based on our fundamental inability to see the future. Regulatory decisions are, of course, often based on reasonable expectations of near and long-term possible futures. Nevertheless, we have never claimed that the particular result we anticipate is anything more than likely. To achieve a reliable and "certain" estimate of rates under ROR for a five year period, however, would require predictive accuracy far beyond our powers: we would have to know, for example, the impacts of competition in all of Verizon's services, since ROR regulation puts the risk of revenue loss squarely on local ratepayers; the rate of inflation and changes in capital costs; the pace of productivity improvements within Verizon and whether we would conclude those were prudent; and the degree to which external events might influence Verizon's costs in ways that would be treated differently under ROR than under AFOR regulation. The Law Court's assertion that "ensuring the objectives with certainty required by Section 9103 is no easy task" is surely an understatement.

Significantly, Verizon, the OPA, and AARP have not suggested any way to produce the "reliable" estimate of rates under ROR. Verizon presented material that showed that in general, price cap regulation produces rates that are in virtually all cases *likely* to be lower than rates under ROR regulation; but Verizon did not offer ideas on how to calculate rates that would *in fact* would be in place in Maine under ROR regulation. The OPA, on the other hand, proposed a full, or nearly full, rate case,[4] but that evidence would be useless to determine whether rates *over the term of the AFOR* under ROR regulation would be higher or lower than under the AFOR. Knowing what the starting point is under ROR regulation provides no certainty at all with respect to

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[4] The Public Advocate proposed what he characterized as a "mini-Chapter 120." (Chapter 120 of the Commission's Rules describes the information a utility must file when it files a "general rate case," i.e., a proposed increase in rates of 1 percent or more.) In fact, however, the Public Advocate described a filing that would be remarkably close to what is required by Chapter 120 except for pre-filed testimony by the utility. The Public Advocate described in detail his witnesses' qualifications, and then summarized some of the adjustments they would propose and other issues they would address.

future rates under ROR; this, indeed, is one of the major differences between ROR and AFOR regulation. Under an AFOR, while rate changes are permitted for certain "exogenous" events, the rate levels remain unaffected by changes in the economy or the competitive landscape.

The "certain" prediction about ROR rates required under Section 9103(1) requires judgments about the future that cannot realistically be made. Even during periods of relative stability, predicting rates for the next five years under traditional regulation would be a daunting task. But the telephone industry is not in a stable period. Rather, it is experiencing enormous regulatory, technological, and market changes. The Triennial Review order recently issued by the FCC provides an indication of the numerous changes that are likely to occur in the next few years. *Review of the Section 251 Unbundling Obligations of Incumbent Local Exchange Carriers et al*., CC Docket No. 01-338 et al., Report and Order on Remand and Further Notice of Rulemaking, FCC 13-36 (August 21, 2003). There are a number of factors that could result in dramatic changes in basic rates under ROR. One is the possibility of competition for local exchange service, from CLECs, wireless carriers, cable television companies or VOIP (voice over internet protocol), that could result in the need for basic rates to rise substantially as the customer base erodes. It is apparent that CLECs (by their concentration on serving business customers) are more interested in larger customers. Wireless carriers offer a variety of calling plans that include a large number of "free" minutes or unlimited usage; that usage may apply to calls that, with wireline service, would be either local and toll. Verizon (and some independent incumbent LECs) have already experienced losses in access lines. Verizon, in compliance with one of the requirements of the AFOR, has demonstrated substantial toll revenue loss; the competition offered by the wireless calling plans described above may have contributed to this decline. The extent of this and other changes cannot be determined in advance by the kind of evidence that the OPA suggests we examine.

Moreover, the ROR proceeding sought by the OPA cannot logically satisfy 9103(1). Rates under five years of ROR regulation would be lower only if *both* of the following conditions were met: first, that initial rates set at the beginning of the AFOR period would be different than those now established; and second, that for five years, ROR would not produce increases in rates beyond those that would occur under the AFOR. The second assumption, however, ignores the real possibilities that costs under ROR will rise above what costs would be under an AFOR, and that those cost increases would be passed on in rates. The first condition might be achieved, i.e., we might find in an ROR case that the starting point would be different. The second condition, however, is not predictable with any reasonable certainty, and might itself be influenced by the very process (a rate proceeding that might act to reduce incentives) used to attain the first condition.[5]

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[5] The Public Advocate's approach also ignores the implications of the strong possibility that Verizon's costs might be lower today as a result of over seven years of alternative regulation. A rate case that showed lower costs might be argued as justification for returning to ROR regulation. Initial rates under the ROR regulation might

The Public Advocate's continued position that a rate case is the answer was presented most recently in response to our request for how to satisfy the *five-year comparison* required by Section 9103(1). His answer implies that if that rate case produces a lower starting point at the beginning of the new AFOR, Section 9103(1) will be satisfied with nothing more. Beyond the offer of a rate case that would show current costs, the Public Advocate has presented nothing that would be useful in predicting local rates for remaining five years of ROR regulation. Our conclusion about the Public Advocate's position is reinforced by the following statement in his April 29, 2003 comments:

> Once the cost-based rate for local service is determined, the required comparison under §9103(1) can be satisfied. While it may be technically true that without a stay-out, rates could decrease under ROR (and thereby not be lower under the AFOR), the Public Advocate does not believe that the Legislature intended for the Commission to have a crystal ball. However, the Legislature and the Law Court have a reasonable expectation that, *at least at the outset of any AFOR*, the Commission should ensure that local rates under an AFOR are no higher than a current ROR-based local rate (emphasis added).

The Public Advocate appears to misunderstand the statutory test that requires a comparison of rates over the duration of an AFOR. By misunderstanding the statutory test, the OPA effectively proves what it denies: that a crystal ball is in fact necessary.

Finally, the OPA also ignores another important feature of ROR regulation: even if a cost of service case indicated that Verizon needed an overall level of revenues less than those that current rate levels produce, and even if each subsequent ROR case produced similar results, it is entirely possible that the rate design decisions of the Commission in the future would require substantial increases in basic rates. Predicting how the revenues from all of Verizon's services will fare over a five-year period, and what competitive and other pressures may come to bear on all of those revenues, is simply beyond our ability to achieve with the requisite certainty.

IV. REINSTATING THE AFOR

A. Public Interest Determination

While we cannot provide ensure the objective stated in 35-A M.R.S.A. § 9103(1), we conclude that there are sound policy reasons for reinstating the AFOR. We have "specifically [found] that [full technical compliance with section 9103(1) is] not in

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be lower, but higher later on *because* of the return to ROR (on the assumption that the lack of incentives causes inefficiencies). Under this hypothesis, the lower initial rates would lead to the ironic result of rejecting a future AFOR because of the low costs produced by a past AFOR, but, in the end, result in higher costs and rates.

the best interests of ratepayers." 35-A M.R.S.A. § 9103; *OPA v. PUC/Verizon,* 2003 ME 23, ¶29. As indicated by the Court, the Commission may "conclude that it is better to proceed with the AFOR without fully complying with the literal language of section 9103(1)." We so conclude.

We find that it is in the public interest and in the interest of ratepayers to reinstate the AFOR. Incentive regulation is well-established both in Maine and in the United States, and, if operating correctly, meets the set of objectives laid out in legislation by encouraging efficient operations and lower costs and prices to ratepayers. We find that the stability and predictability in rates, and the service quality guarantees, that an AFOR – but not ROR regulation – can produce have real benefit for the public. We note that, apart from disagreeing about the proper starting point, the OPA has found no fault with the particular AFOR that we adopted in 2001 and reinstate here. Under AFOR regulation, Maine's overall prices have declined relative to national trends, and Maine's penetration rate (i.e., the percentage of households with telephone service) is consistently among the very highest in the country. See our priorOrder Denying OPA Request for Revenue Requirement Case in this docket (June 20, 2000) at 10. Our experience with other utilities is also positive: the first alternative rate plan (ARP) for CMP resulted in significant savings for consumers, because they were insulated from the major, and wholly unanticipated, expense of resleeving the steam tubes at Maine Yankee. AFOR (and ARP) regulation has substantially reduced regulatory costs, has spurred an appropriate degree of investment (Maine's telecommunications infrastructure remains fundamentally sound), has encouraged the deployment of new services, and in general satisfies all of the objectives of section 9103 with the possible exception of subsection 1. It would not be in the interest of ratepayers to sacrifice these benefits merely because it is impossible to satisfy the "equal futures" test of Section 9103(1).

As set forth in greater detail in the June 25, 2001 Order, the reinstated AFOR includes rate caps for local exchange service, subject to rate changes for changes in basic service calling areas (BSCAs),[6] the possible elimination of rate

[6] Under the BSCA Rule, Chapter 204, the Commission may order an increase in local rates in conjunction with expanding a BSCA. Pursuant to recent amendments to the BSCA rule, all BSCAs will include all contiguous exchanges. That expansion is expected to occur in December, 2003.

groups,[7] or further required access rate reductions; [8] rate caps for directory assistance and operator services; rate flexibility for retail toll and optional services; and the Service Quality Index (SQI). Access rates are subject to the provisions of 35-A M.R.S.A. § 7101-B and Commission orders issued pursuant to that section.

B. The Status of Present Rates.

The rates for various services that were in effect at the time of our June 2001 order that established the revised AFOR, including the $1.78 increase to account for the decrease in access rates, have exactly the same legal status as rates that might be found under a full ROR case. No one has argued that the starting point for the first AFOR was not appropriate; no one challenged the terms of the first AFOR; and no one contested the rate adjustments made by the commission during that AFOR. The rates that went into effect in June 2001 were the direct product of the AFOR, and ultimately traceable to ROR regulation; some (specifically, the local exchange service rates) were

[7] The Commission will soon consider an Examiner's Report recommendation that we approve Verizon's proposal to eliminate rate groups at the same time as the BSCA expansion. *Maine Public Utilities Commission, Investigation of Proposed Rate Design by Verizon Maine to Eliminate Multiple Rate Groups Through Consolidation Into a Single Statewide Rate Group*, Docket No. 2003-512, Examiner's Report (September 19, 2003). Under the recommendation, any elimination of rate groups would be on a revenue-neutral basis, so that rates for rate groups with smaller calling areas would increase and those for rate groups with larger calling areas would decrease.

[8] We discussed this possibility in the *2001 AFOR Order* at 18-19. We noted that future expected access rate decreases are likely to be much smaller than the 2001 decrease, that "their size may raise questions about whether they should be considered exogenous and subject to a pass-through in rates," and that Verizon was free "to decide whether it should seek to justify, under the rules of the revised AFOR, any changes to basic rates based on the 2003 access reductions." Recent changes to 35-A M.R.S.A. § 7101-B (effective on May 2, 2003, pursuant to emergency legislation enacted by P.L. 2003, ch. 101) moved the next absolute deadline for reducing intrastate access rates to interstate levels to May 31, 2005. The statute, however, grants the Commission some discretion to order parity by an earlier date. We have opened a proceeding to require Verizon to propose a schedule for compliance with the amended statute. *Public Utilities Commission, Investigation of Compliance of Verizon Maine with Amended 35-A M.R.S.A. § 7101-B,* Docket No. 2003-358, Notice of Investigation (May 28, 2003). Verizon has filed a proposal to delay any further access rate reductions until May 31, 2005. A notice of an opportunity to intervene in that proceeding and to file comments about Verizon's proposal has been sent to carriers and other persons.

directly derived from prior ROR regulation.[9] In any event, the rates now in effect are a result of a process that is fully as lawful as "pure" ROR regulation, and are therefore just and reasonable.

C. Whether to Reset the Starting Point

Beyond the questions that we needed to address under Section 9103, and beyond the courts mandate on remand, we also consider, as a matter of Commission policy, whether we should reset rates pursuant to an ROR determination when we revise an AFOR or start a new one. Such an exercise would be wholly different from that required by §9103(1) or by the Court's remand. It has nothing to do with the five-year comparison between different systems of regulation that we would need to make if we were to attempt to ensure the objective under Section 9103(1). Although the OPA purports to argue that a rate case would satisfy the Section 9103(1) objective, its argument actually seem to suggest that the Commission should conduct a rate case for the purpose of resetting rates at the outset of the revised AFOR.

We do not believe that the public is best served by imposing such a requirement in this case. The point of an AFOR is to remove the disincentive, well documented in traditional ROR regulation, for utilities to become as efficient as possible, and to reduce their costs as much as possible consistent with providing safe and adequate service. These disincentives return, however, if utilities under an AFOR are faced with the prospect of having the cost savings captured in periodic rate cases, even if the period of regulatory lag is somewhat lengthened. It is plausible that a utility, finding that the efficiencies achieved during a first AFOR lead to price reductions in an ROR case before the next AFOR is begun, will wonder whether the effort and investment needed to achieve those savings are really worth the trouble. The Public Advocate has never adequately addressed this point.

The Public Advocate's arguments raise the question of what type of inquiry the Commission should it make, if any, to determine that the starting point for a new or revised AFOR is reasonable. As discussed above, the rates in effect at the end of the initial AFOR are definitionally lawful, i.e., "just and reasonable" as required by 35-A M.R.S.A. § 301. Beyond that, there is information in this case to indicate that rates are

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[9] All of the present rates can be traced back to the 1995 ROR decision in the *Pease* investigation, Docket No. 95-254, that served as the starting point of the first AFOR. "Core" rates were subject on an overall basis to the price regulation index (PRI) that took into account inflation, productivity and exogenous changes, and that was negative in each year of the AFOR. Thus, rates as a whole declined. A specific pricing rule that governed local service rates prohibited increases to those rate unless the PRI was positive; it never was. The only increases to local rates during the course of the initial AFOR were for exogenous or exogenous-like changes: the $3.50 increase ordered in 1999 to partially offset the substantial access rate decreases required by statute and smaller increases to offset toll revenue losses from BSCA expansions.

in fact reasonable measured against objective standards such a national trends and the rates prior to the initial AFOR. No party has claimed that the productivity offset established for the first five years of the AFOR or the resulting level of rates were unreasonable. A revenue requirements proceeding (as the OPA consistently insisted we should do) has the potential for undermining efficiency incentives; it also incurs the kind of regulatory costs that incentive regulation seeks to avoid.

We do not decide that we will never undertake such a proceeding in a future case. Nor do we suggest that, once a first AFOR has been implemented, rates must proceed under the same AFOR forever, or that we should presume that no examination of rates outside the particular AFOR formulas will ever be appropriate. It is certainly possible that there could be significant, unanticipated economic changes allowing for efficiency savings well beyond those contemplated by the express productivity factor in the initial AFOR and the implicit productivity factor in the revised AFOR.[10] In such a situation, some adjustment in a new rate formula might be made without eroding the efficiency incentive. We may consider that issue on a generic basis in a future proceeding. At some point, we may also consider a more systematic review of how Maine's incentive rate plans have performed, to inform both ourselves and the Legislature about what changes, if any, we might wish to implement or recommend to improve their workings.

Absent a strong indication that such a proceeding is necessary, we believe that once the cord between earnings and rates has been cut, we should be wary of restoring the link. To the extent that we believe some test external to the AFOR is needed to assess the reasonableness of rates, that test most likely should not be linked to earnings which, in theory and practice, are themselves the product of an AFOR.[11] We might, for example, look to how rates in other jurisdictions have moved, whether rates are still affordable (i.e. has our penetration rate fallen), and whether there have been

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[10] The productivity factor in the revised AFOR is inflation plus the expectation that Verizon will be able to cover retail toll losses (already demonstrated) with efficiency gains.

[11] Although the Public Advocate continues to raise the possible savings that may have resulted from the NYNEX-Bell Atlantic merger, it has not provided any indication how these would be proven in a rate proceeding. It is likely that any such gains are part of the efficiency gains recognized in the productivity factors of the initial and revised AFORs. It is unlikely that a rate proceeding would uncover an identifiable pot of savings or that it would be sound policy to strip Verizon of those savings if they were found. As we indicated at the time of approving the merger, a merger was within the scope of activities that could lead to efficiency gains anticipated in the productivity factor. We also stated our concern that flowing through savings might weaken the AFOR incentives. *New England Telephone and Telegraph Co. and NYNEX Corp., Joint Petition for Proposed Reorganization Intended to Effect the Merger with Bell Atlantic Corporation*, Docket No. 96-388, Order (Part II) at 14.

quantum gains in productivity (or dramatic changes in costs driven by, for example, new technologies) that suggest more aggressive productivity targets in the future. The application of traditional rate of return principles to setting rates that are themselves the product of an AFOR is fundamentally contradictory and will blunt, to no particularly good purpose, the very object of the alternative form of regulation that the Legislature has concluded may be superior, and the Commission has concluded *is* superior, to traditional regulation.

Accordingly, we

1. FIND, as permitted by the introductory paragraph of 35-A M.R.S.A. § 9103, that it is not in the best interests of ratepayers, because not reasonably possible, to ensure the objective stated in 35-A M.R.S.A. § 9103(1); and

2. REINSTATE the alternative form of regulation originally ordered in the Commission's Order (Parts 1 and 2) of May 9 and June 25, 2001.

Dated at Augusta, Maine, this 25th day of September, 2003.

BY ORDER OF THE COMMISSION

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Dennis L. Keschl
Administrative Director

COMMISSIONERS VOTING FOR: Welch
Diamond
Reishus

NOTICE OF RIGHTS TO REVIEW OR APPEAL

5 M.R.S.A. § 9061 requires the Public Utilities Commission to give each party to an adjudicatory proceeding written notice of the party's rights to review or appeal of its decision made at the conclusion of the adjudicatory proceeding. The methods of review or appeal of PUC decisions at the conclusion of an adjudicatory proceeding are as follows:

1. Reconsideration of the Commission's Order may be requested under Section 1004 of the Commission's Rules of Practice and Procedure (65-407 C.M.R.110) within 20 days of the date of the Order by filing a petition with the Commission stating the grounds upon which reconsideration is sought.

2. Appeal of a final decision of the Commission may be taken to the Law Court by filing, within **21** days of the date of the Order, a Notice of Appeal with the Administrative Director of the Commission, pursuant to 35-A M.R.S.A. § 1320(1)-(4) and the Maine Rules of Appellate Procedure.

3. Additional court review of constitutional issues or issues involving the justness or reasonableness of rates may be had by the filing of an appeal with the Law Court, pursuant to 35-A M.R.S.A. § 1320(5).

Note: The attachment of this Notice to a document does not indicate the Commission's view that the particular document may be subject to review or appeal. Similarly, the failure of the Commission to attach a copy of this Notice to a document does not indicate the Commission's view that the document is not subject to review or appeal.